

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201221008**
Release Date: 5/25/2012
Index Number: 1362.04-00

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact: , ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-140399-11
Date:
February 24, 2012

LEGEND

X =

State =

Date1 =

Date2 =

Date3 =

Year1 =

Year2 =

Year3 =

Year4 =

Year5 =

Year6 =

Year7 =

\$K =

\$L =

ShareholderA =

Remedial Distributions =

Dear :

This responds to a letter dated September 27, 2011, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

Facts

According to the information submitted and representations made, X was incorporated under the laws of State on Date1. X elected to be treated as an S corporation for Federal tax purposes effective Date2. At the time of the S election, X had C corporation accumulated earnings and profits ("AE&P"). For each of the consecutive taxable years ended Year1, Year2, and Year3, X had passive investment income, within the meaning of § 1362(d)(3)(C), in excess of 25 percent of its yearly gross receipts. As a result, X's S election terminated on Date3.

X made disproportionate distributions to its shareholders in taxable years Year4, Year5, Year6, and Year7. These disproportionate distributions may have created a second class of stock. X represents that under its governing provisions, all of X's shares of stock possess identical rights to distribution and liquidation proceeds. X further represents that neither X nor its shareholders knew that disproportionate distributions could terminate X's S corporation election. X will make Remedial Distributions to its shareholders upon the issuance of a favorable letter ruling.

X represents that the circumstances resulting in the termination of its S election on Date3, as well as the potential creation of a second class of stock during Year4, Year5, Year6, and Year7 were inadvertent, and that since Date2 X and its shareholders have filed returns consistent with X's status as an S corporation. X and its shareholders agree to make adjustments (consistent with the treatment of X as an S corporation) as might be required by the Secretary.

Additionally, during Year4, X distributed \$K to its shareholders. X treated this distribution as paid from AE&P, and distributed Forms 1099-DIV to its shareholders. The shareholders reported their respective shares of the purported dividend as dividend income on their individual returns, except that \$L of ShareholderA's distribution was inadvertently not reported as a dividend. X's accountants did not attach the election required for this treatment under § 1368(e)(3)(A) to X's tax return for Year4.

Rulings Requested

1. X requests a ruling that the termination of its S election on Date3 will be treated as an inadvertent termination under § 1362(f).
2. X requests a ruling that if the disproportionate distributions during Year4, Year5, Year6, and Year7 created a second class of stock resulting in a termination of its S election, such termination will be treated as an inadvertent termination under § 1362(f).
3. X requests an extension of time under § 301.9100-3 of the Procedure and Administration Regulations to file an election under § 1368(e)(3)(A) to treat the distribution of \$K in Year4 as a distribution paid from AE&P.

Law and Analysis

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of such years more than 25 percent of which are passive investment income. Section 1362(d)(3)(A)(ii) provides that any termination under § 1362(d)(3) shall be effective on

and after the first day of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i).

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25 percent of which are passive income (within the meaning of § 1362(d)(3)).

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, in part, that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides, in part, that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1368(c) provides rules for determining the source of distributions made by an S corporation having accumulated earnings and profits with respect to its stock. Section 1368(e)(3) and § 1.1368-1(f)(2) provide that an S corporation may, with the consent of all its affected shareholders, elect to distribute accumulated earnings and

profits first.

Section 1.1368-1(f)(3) provides that an S corporation may elect to distribute all or part of its accumulated earnings and profits through a deemed dividend. If an S corporation makes the election provided in § 1.1368-1(f)(3), the S corporation will be considered to have made the election under § 1368(e)(3) and § 1.1368-1(f)(2) to distribute accumulated earnings and profits first. Section 1368-1(f)(5) provides that a corporation makes an election for a taxable year under § 1.1368-1(f) by attaching a statement to a timely filed original or amended return. In the statement, the corporation must identify the election it is making under § 1.1368-1(f) and must state that each shareholder consents to the election. In the case of elections for taxable years beginning after December 31, 2002, the statement shall be verified by signing the return. A statement of election to make a deemed dividend under § 1.1368-1(f) must include the amount of the deemed dividend that is distributed to each shareholder.

Section 301.9100-1(c) provides that the Commissioner may grant a reasonable extension of time to make a regulatory election, or a statutory election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Internal Revenue Code except subtitles E, G, H, and I. Section 301.9100-1(b) defines the term "regulatory election" as an election whose due date is prescribed by a regulation published in the Federal Register or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

Sections 301.9100-1 through 301.9100-3 provide the standards the Commissioner will use to determine whether to grant an extension of time to make the election. Section 301.9100-2 provides the rules governing automatic extensions of time for making certain elections. Section 301.9100-3 provides the standards the Commissioner will use to determine whether to grant an extension of time for regulatory elections that do not meet the requirements of § 301.9100-2. Under § 301.9100-3, a request for relief will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that (1) the taxpayer acted reasonably and in good faith, and (2) granting relief will not prejudice the interests of the government.

Conclusion

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on Date3, the first day of the first taxable year after three consecutive years in which X had AE&P, and also in which more than 25 percent of its income was passive investment income under § 1362(d)(3)(A). We further conclude that the termination of X's S election on Date3 was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after Date3, unless X's S corporation election is otherwise terminated under § 1362(d), and provided that X distributes its AE&P to its shareholders within 120 days of the date of this letter and the shareholders report their

shares of this distribution as a dividend on their federal tax returns. This ruling is contingent on X and ShareholderA including the \$L inadvertently not reported as a dividend during Year4 as part of X's remaining AE&P being distributed within 120 days of the date of this letter.

Additionally, we conclude that if X's S corporation election was terminated for having more than one class of stock as a result of making disproportionate distributions, such termination constituted an inadvertent termination within the meaning of § 1362(f). Accordingly, X will be treated as continuing to be an S corporation from Date3, and thereafter, provided that X's S corporation election is not otherwise terminated under § 1362(d). This ruling is contingent upon X making Remedial Distributions within 120 days of the date of this letter for taxable years Year4, Year5, Year6, and Year7 — taxable years in which it made disproportionate distributions to its shareholders. The shareholders of X must include their pro rata shares of the separately stated and nonseparately computed items of income or loss of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X fails to make such Remedial Distributions or X's shareholders fail to treat themselves as described above, this ruling shall be null and void.

Additionally, based solely on the facts submitted and the representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. As a result, X is granted an extension of time of 120 days from the date of this letter to make a § 1368(e)(3)(A) election for taxable year Year4 by filing an amended return for taxable year Year4, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend in the amount of \$K minus \$L.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed regarding X's eligibility to be an S corporation. Further, no opinion is expressed as to whether X's income was passive investment income under § 1362(d)(3)(C).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely,

Joy Spies

Joy Spies

Acting Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for § 6110 purposes